requirement would merely reduce the burden on the FCC and other regulators of monitoring affiliate transactions. By requiring that information be made publicly available and included as part of the CAMs, the goal of "ensuring that each affiliate will conduct all transactions with the BOC on an arm's length basis" will be enhanced.

As stated elsewhere in these comments, there is a significant incentive for the BOCs and LECs to cross-subsidize between their regulated and nonregulated operations, including nonregulated affiliates. The burden of monitoring this potential is immense and will increase with implementation of the 1996 Act. By requiring that the transfer pricing information be made publicly available, the Commission will greatly enhance its oversight abilities because any abuses can be brought to the Commission's attention by other interested parties. The BOCs and LECs will likely claim that such information is proprietary. The APCC does not see how this information could be considered proprietary. The only information that might be considered proprietary would be pricing transfers based upon fully distributed cost. All other pricing mechanisms should not involve proprietary information as they would be based upon tariffed rates, prevailing market prices, or fair market value. None of this information should be considered proprietary. Furthermore, with respect to fully distributed cost, for the sake of ensuring arm's length transactions, the Commission should find that the BOCs and LECs bear the burden of demonstrating that such information warrants confidential or proprietary status. The burden should be a heavy one. Otherwise, the BOCs/LECs will be able to use proprietary status as a vehicle to avoid detection of subsidies.

There have been numerous instances where state and joint federal-state audits have found that transactions between the BOC and their affiliates are less than arm's length. See Attachment 2. With more of the BOCs/LECs operations placed in the nonregulated category, the potential for undetected abuses of affiliate transactions will increase. Therefore, the Commission should require that all contracts, studies, and other documents used to develop the transfer price between the BOCs and LECs and their unregulated affiliates be made publicly available and made part of the annual CAMs filed with the Commission.

C. Public Inspection

The Commission seeks comments on whether it should amend its rules to address Section 272(b)(5)'s requirement that all transactions be "reduced to writing and available for public inspection." In particular, the Commission has asked if Internet access would be sufficient to comply with the requirement for public access. The Commission also requests comments on other methods it could implement to comply with Section 272(b)(5) and what protection, if any, is needed to protect sensitive and confidential information.

APCC recommends that the public inspection requirement to be imposed with respect to Section 272(b)(5), be imposed on all transactions with the BOCs/LECs and their affiliates. The dangers of affiliate abuses are no less for the numerous transactions that currently exist and those that will exist in the future, than they are with respect to manufacturing and interLATA services. The APCC will not reiterate the comments addressed above; however, it is vitally important for the protection of ratepayers and to encourage robust competition that all transactions with affiliates be reduced to writing and be available for public inspection. While the APCC supports the Commission initial conclusion that the information should be available through Internet access, the APCC notes that not all interested parties have the capability or knowledge to efficiently access the Internet. Accordingly, the Commission should require that the information be submitted as part of the BOC/LECs Cost Allocation Manuals as well as through the Internet. This would aide in the efficiency with which affiliate transactions could be monitored by placing all the necessary and relevant information on these transactions in one complete and comprehensive document. Parties would not be required to access different media to comprehend the complete picture. With respect to the need to adopt safeguards for sensitive information, the burden of proving the need for confidentiality should be a heavy one which rests squarely on the shoulders of the BOCs/LECs.

D. Valuation Of Assets And Services

The Commission requested comment on its tentative decision to prescribe uniform valuation methods for all affiliate transactions. In particular, the Commission has proposed to modify its current rules regarding the valuation of affiliate services. These rules now state that transfers of assets that are neither tariffed nor subject to prevailing company prices, are to be recorded at the higher of net book cost or estimated fair market value when the carrier is the purchaser, and at the lower of net book cost or estimated fair market value when the carrier is the buyer. In transactions involving services, however, current affiliate transaction rules require that all services that are neither tariffed nor subject to prevailing company prices, be recorded at the provider's fully distributed cost.

The APCC agrees with the Commission's tentative conclusion, in the Affiliate Transaction Notice, that such treatment of services may provide an incentive to companies to buy services from an affiliate for more than, and sell services to its affiliates for less than, fair market value. However, APCC has some concerns with the Commission's proposal to require affiliate transactions involving non-tariffed services, as well as assets, be recorded at the higher of cost or estimated fair market value when the carrier is the seller, and at the lower of cost or estimated fair market value when the carrier is the purchaser.

The Commission proposes sales by an affiliate to a carrier should be recorded at the lower of fully distributed cost or fair market value. This proposal is based upon the presumption that an affiliate transaction involves lower marketing costs and less business risk than an arm's length transaction. For example, marketing techniques such as sales presentations, advertising campaigns, and volume discounts are not needed to complete a sales transaction with an affiliate. This difference is not built into the price if it is based upon prevailing market rate. Thus, to the extent that an affiliate provides services, products, or assets to the BOC, the price established by a prevailing market rate could easily overstate the true cost to provide this service, product, or asset to the BOC. The Commission noted that using prevailing prices to value asset transfers could permit affiliates to charge inflated prices to the BOC. This in turn would allow a nonregulated affiliate to receive added revenue that could permit the nonregulated affiliate to price other competitive assets and services lower to the detriment of fair competition.

The Commission's conclusions appear to be based upon two factors. The first is that the logic behind the prevailing market prices for transactions between a carrier and an unregulated affiliate, when that affiliate's primary purpose is to provide services to the carrier or other affiliates, breaks down. Essentially, under these conditions, there is no prevailing market price that could be used as a basis for transfer pricing. Under these circumstances, the APCC agrees with the Commission. However, as pointed out below, if there is an outside market, the prevailing market rate should be used as the benchmark to judge the reasonableness of fair market value or fully distributed cost.

The second is that the prevailing market price may overstate the costs actually necessary to provide the same services to an affiliate. In other words, there is less cost for an affiliate to provide the same service to an affiliate than to a non-affiliated party. The prevailing market price would thus overstate the cost to the regulated carrier and overstate the revenue to the affiliate.

While the APCC recognizes attractiveness of this proposal when the carrier is the <u>buyer</u> of services, there are different concerns when the carrier is the <u>seller</u> of services to an affiliate. While in theory the Commission's proposal makes sense, in application, it presents problems due to the lack of objective measures of transfer prices. While the prevailing market price suffers from some problems, as noted by the Commission, it is more objective, although also subject to interpretation, than fair market value or fully distributed cost. Where the carrier provides services to an unregulated affiliate, removal of the prevailing market price valuation. The absence of a prevailing price valuation could provide an incentive for the regulated carrier to under price services to its unregulated affiliates.

Due to the inherent problems associated with determining fair market value and fully distributed costs, the Commission should retain the prevailing market price as the price maximum when the affiliate provides services to the carrier. In other words, if either fair market value or fully distributed cost is higher than the prevailing market rate, this should present a red flag to the Commission that the prices determined using the lower of fully distributed cost or fair market value are overstated. In fact, when the nonregulated affiliate provides services to the regulated carrier, its prices should always be less than the prevailing market rate. Yet, under the Commission's proposal, there will be no method of easily and objectively assessing the reasonableness of the lower of fair market value or fully distributed cost. For this reason, the APCC recommends that the Commission retain the use of the prevailing market rate, such that the price determined based upon the lower of fair market value or fully distributed cost cannot exceed prevailing market rate, and that the price should be lower than the prevailing market rate. Thus, the Commission's rules would require that services, products, or assets provided by an unregulated affiliate to the carrier, shall be lower than the prevailing market rate, and would be recorded as the lower of fair market value or fully distributed cost.

Since it is clearly the Commission's intention to ensure that the regulated carrier's operations do not subsidize the unregulated affiliates operations, requiring that transfer prices be the higher of prevailing market price, fair market value, or fully distributed cost would accomplish this goal. Removal of the prevailing market price would remove from the transfer valuation methods, the most objective measure available. Alternatively, the Commission can establish the prevailing market rate as the price floor. Under this alternative, use the higher of fair market value or fully distributed cost could not be lower than prevailing market prices. This would ensure that the BOCs/LECs do not have the ability to prices services to their affiliates that are lower than the price charged to their competitors. Without an objective benchmark to determine the reasonableness of the transfer prices from the carrier to the affiliate, there will be a tremendous incentive for the carriers to underprice services to their affiliates and overprice services to their competitors. APCC recommends that the Commission modify its affiliate transaction rules so that transfers from the carrier to the affiliates be priced at the higher of prevailing market prices, fair market value, or fully distributed cost. Alternatively, the prevailing market price would be the benchmark, such that transfers from the carrier to the affiliate cannot be lower than the prevailing market price and would be determined to be the higher of fair market value or fully distributed cost.

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ATTACHMENT 1

Recent State Decisions Re Royalty Fees

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In 1989, the Kansas Corporation Commission approved a 5% royalty fee to compensate United Telephone Company of Kansas for the intangible benefits it conferred on United Telephone Long Distance Company of Midwest, an affiliate. <u>In the Matter of the Application of United Telephone Company of Kansas, for Permission and Authority to Establish a New Schedule of Rates Applicable to Exchange Telephone Service and Non-Recurring Charges Applicable to All of Its Exchanges in the State of Kansas</u>, Docket No. 162,044-U, Order Dated May 22, 1989, at 30.

In 1988, the Florida Public Service Commission ordered that United Telephone Company of Florida be compensated for the intangible benefits it conferred on its long distance service affiliate. The Florida Commission required the affiliate to pay up to 2.8% of the difference between net revenue and origination and termination access charges to the local exchange company. <u>Application of United Telephone Long Distance For Resale Certification</u>, Docket No. 870285-TL, Order No. 18939, issued March 2, 1988, <u>aff'd United Telephone Long Distance v. Nichols</u>, 546 So. 2d 717 (Fla. 1989).

In 1991, the Connecticut Department of Public Utility Control ("DPUC") ordered an imputation be made to the revenue of Southern New England Telephone Company ("SNET") to reflect use of its SNET acronym by its holding company parent and the parent's unregulated subsidiaries. The DPUC ordered that 4% of the revenue from the parent company's unregulated subsidiaries would be imputed to SNET while the value of the acronym was being established by an independent appraiser. <u>DPUC Investigation Into the Rate Structures and Operational Financial Status of the Southern New England Telephone Company</u>, Docket No. 89-12-05, Decision - Phase I, issued March 20, 1991.

In 1992, the Corporation Commission of the State of Oklahoma adopted a 5% royalty on certain sales of two affiliates of Southwestern Bell Telephone Company. <u>In the Matter of the Application of Howard W. Motely, Jr. For an Inquiry into the Rates and Charges of Southwestern Bell Telephone Company</u>, Cause No. PUC 000662, Order No. 367868, issued August 26, 1992.

In <u>Minnegasco v. Minnesota Public Utilities Comm'n</u>, 529 N.W. 2d 413 (Minn. App. 1995), the Minnesota Court of Appeals upheld a commission ruling that a gas utility must value the goodwill of the utility that benefits its nonregulated appliance business, and impute the valuation as revenue to the regulated side.

In Rochester Telephone Corp. v. Public Service Comm'n, 660 N.E. 2d 1112 (N.Y. 1995), the New York Court of Appeals affirmed a 1993 commission ruling that imposed a 2% royalty on Rochester Telephone to compensate ratepayers for intangible assets transferred to the company's nonregulated subsidiaries. The Commission also created a rebuttable presumption of a 2% royalty whenever a utility invests in nonregulated enterprises.

ATTACHMENT 2

News Reports Re Audits of Affiliate Transaction

Bell Audits Find Common Problems, NARUC Told

*Federal-state audit teams, recently completing affiliate transaction audits, have found that deficiencies in Bell companies' project tracking and accounting procedures are a common problem. The Bell company audits were launched by a National Association of Regulatory Utility Commissioners resolution adopted in 1991. NARUC last week received reports on three completed reviews—the audits of BellSouth Telecommunications, Inc., Southwestern Bell Telephone Co., and Pacific Bell. While the BellSouth study was completed in late 1993, requests for more information from the company are outstanding (*TR*, April 4). The Southwestern Bell audit was released by the FCC earlier this year (*TR*, May 23).

The NARUC/Federal Staff Audit Oversight Committee reported that a draft of the Ameritech Corp. audit report has been submitted to the company for comments, which are expected early this month. The Bell Atlantic Corp. audit, in which the Pennsylvania and District of Columbia commissions are participating, has just gotten under way. A final report is not expected until September, 1995.

The NYNEX Corp. audit remains on hold while Liberty Consulting Group investigates whether an audit it is conducting for the New York Public Service Commission has been tainted. Telephone company staff last year improperly obtained a copy of the draft audit report. NYNEX-New York recently completed its own review of the incident and has disciplined several employees (*TR*, April 25). Liberty is expected to brief the PSC on its findings this month. A multi-state audit of U S WEST Communications, Inc.'s affiliate dealings was conducted separately from the NARUC project.

The oversight committee is expected to initiate another major audit of a telecommunications company at the September meeting of NARUC's accounting staff subcommittee in Lexington, Ky. GTE Corp. is expected to be the target of this audit, in which the FCC also will participate if "joint federal-state audit issues can be identified by the participants." The committee has asked jurisdictions that want to participate in the project to suggest areas for audit.

Besides the need for better project tracking and accounting procedures, the committee last week noted that the reviews of Pacific Bell's and BellSouth's affiliate transactions highlight other common problems. (The Southwestern Bell study was a different kind of audit—a review of the company's compliance with federal cost allocation and accounting rules.) Similar problems discovered in the BellSouth and Pacific Bell audits included:

*

- "Charging research and development costs for competitive products and services to the ratepayers;
- "Allocating costs of competitive ventures to the ratepayers;
- "Transferring assets to nonregulated affiliates to shield revenues or potential revenue streams from regulation; and
- "Enhancing network infrastructure facilities, with the cost borne by the ratepayers, to position the nonregulated affiliates in the offering of competitive video and information services."

The newly released Pacific Bell audit, conducted by California Public Utilities Commission staff, examined the company's research and development, enhanced services, and Yellow Pages organizations. Regarding the company's R&D efforts, the audit said: "Research and development expense, as defined and tracked by Pacific Bell, is historically a relatively small amount. Yet, billions of dollars are required to build or modify the necessary network infrastructure so that these new Information Age products and services being developed at the research laboratories can be offered.

"There is not a bright line between what should be chargeable to the shareholders vis-a-vis the ratepayers. This artificial line is especially oblique with respect to the accounting for new major platform projects. . .The present regulatory scheme provides the utilities with the incentive and the means to charge the ratepayers with the costs of these Information Age developments."

According to the report, Pacific Bell's subject matter experts working on both competitive and noncompetitive projects have not been segregating their time correctly between the two business sectors. It also criticized the company's "arbitrary recording process" for R&D expense.

The audit closely examined the company's personal communications service and broadband digital communications network R&D. It complained that ratepayer "cost-benefit studies were not performed prior to starting [R&D] and new product development projects."

The enhanced services section of the report said: "All of the new product developments that eventually lead to enhanced services are not captured as product costs, especially those costs incurred prior to the market feasibility stage. Because the enhanced services-related expenditures are commingled with other operating expenses that are funded from baseline budgets, the pre-captured costs are borne by the ratepayers." In addition, the audit found that Pacific Bell "spent millions of dollars to modify its pay phones to accommodate its Pacific Bell Information Services Group. The benefits to ratepayers from retrofitting pay phones have not been quantified by Pacific Bell."

> **PLANT ACCOUNT REDUCTIONS**
>
> In a July 28 public notice, the FCC called for comments by Sept. 2 and replies by Sept. 16 on accounting issues related to plant account reductions Alascom, Inc., was required to take to reflect receipt of the first of two $75 million payments from AT&T Corp.
>
> The AT&T payments were directed in the Commission's order adopting a federal-state joint board's recommendations to end the Alascom/AT&T joint interstate service arrangements (*TR*, May 23).

The audit team noted that it began the investigation of Pacific Bell Directory in late 1992. The investigation found that the company's R&D in electronic publishing and other emerging technologies in the directory field was funded by ratepayers. "As best as can be determined, the ratepayers' funding of these electronic publishing services and products began in the mid-1980s," the report stated. It added, "All [R&D] activities were abruptly discontinued—about 1992—at Pacific Bell Directory. Key personnel and the electronic publishing activities were transferred to an essentially nonregulated subsidiary, Pacific Bell Information Services. After about a year, a further transfer was made of this electronic publishing operation to a newly formed company that is not part of the Pacific Bell corporate structure, another step away from the reaches of the regulatory agency."

The report criticized Pacific Telesis Group (PTG) for removing from Pacific Bell Directory "a potential new source of revenue to offset the potential loss of classified 'yellow page' advertising revenues to emerging electronic publishing competitors and potentially to its newly formed electronic publishing service company, the latter being a form of cannibalization."

The report said: "The [PTG] strategy, if unchanged, has left a billion-dollar regulatory ratemaking asset without the means to enhance in a significant way or even to maintain its industry revenue position over the long term. This change in [PTG's] corporate strategy appears to have been made to ensure that only the shareholders benefit from the electronic publishing development funded by the general body of ratepayers. Current regulatory rules may not be adequate to prevent or deter similar situations from occurring. A situation exists where ratepayers, in essence, provide the seed money and bear the risks, with the potential rewards accruing to the shareholders. There has been no compensation for the ratepayers' multimillion-dollar risk. [PTG's] electronic publishing ventures have been cross-subsidized by the ratepayers."

Pacific Telesis charged that the report is full of misinterpretations and mischaracterizations of its activities. It said it and Pacific Bell have "diligently followed" all affiliate transaction rules. It stressed the view that Pacific Bell's price cap regulatory framework protects California ratepayers. □

Bureau Given 90 Days To Recommend Action on Findings Of SW Bell Audit Conducted with Help of Five States

The FCC last week released, but expressed no opinion on, the findings of a federal-state audit regarding Southwestern Bell Telephone Co.'s affiliate transactions between 1989 and 1992. The audit report concludes that Southwestern Bell Telephone's affiliate dealings "are not in full compliance with the affiliate transaction standards and—depending on [telephone company] earnings and the regulatory process in each regulatory jurisdiction—telephone ratepayers may have been burdened by a potential $93.7 million in excess costs resulting from transactions with two of its affiliates: Southwestern Bell Corp. (SBC), the parent company, and Southwestern Bell Asset Management, Inc. (AMI), the real estate affiliate."

HIGHLIGHTS: Southwestern Bell disagrees with audit team's main findings, says amount questioned represents only 0.004% of telco expenditures during the audit period. . .Missouri staff files report in record of affiliate transaction proceeding. . .Audit hailed as first joint federal-state review involving all state commissions overseeing a Bell company.

The report also criticized SBC's lack of documentation for allocating employee costs to regulated telephone operations. Southwestern Bell Telephone last week said that it disagrees with the audit team's main findings.

Further, the company stressed that its telephone service customers saw "no increase in rates during the audit period. In fact, in two states in our region, basic local service rates declined in recent years," it said. Dan Hubbard, Southwestern Bell Telephone Vice President-revenues and public affairs, added: "Even if the preliminary staff report were ultimately adopted, it is also worth noting that the dollar amount in question represents 0.004% of the expenditures Southwestern Bell Telephone made during the audit period. These preliminary findings will have little or no impact on consumers." The company considered the audit primarily favorable.

The FCC last week directed the Common Carrier Bureau to review the report promptly and recommend possible further action by the Commission within 90 days. The Southwestern Bell audit is the first one of a Bell company conducted by an FCC-state audit team including staff from each state regulatory commission with jurisdiction over the company. Other ongoing Bell company joint audits involve only partial representation of state commissions in the region. The five state commissions involved in the Southwestern Bell audit—Arkansas, Kansas, Missouri, Oklahoma, and Texas—have not expressed an opinion on the audit team's conclusions.

The joint auditors based their review on FCC affiliate transaction standards. How the audit findings will be used by state regulators depends on each jurisdiction's regulations, statutes, and ratemaking standards. Immediately upon the FCC's release of the Southwestern Bell audit report May 19, the Missouri Public Service Commission staff filed the document in its new affiliate transactions docket (TO-94-184). The docket is a follow-on proceeding to the PSC's late-1993 directive that the telco reduce rates by $84 million in excess earnings (*TR*, Jan. 3). Southwestern Bell has challenged the directive in state court.

Hundt Commends Audit's Efficient Use of Resources

Announcing the release of the audit at last week's FCC meeting, Chairman Reed E. Hundt said that the "sum of the federal-state effort is greater than the individual contributions would have been without coordination." He added, "By combining auditing resources, the FCC and the states both are able to enforce more effectively the regulations essential to managing the transition to a competitive telecommunications industry."

The Southwestern Bell audit stemmed from a National Association of Regulatory Utility Commissioners resolution calling for federal-state joint audits of Bell company affiliate transactions (*TR*, Nov.

18, 1991). A multistate audit of U S WEST Communications, Inc.'s affiliate dealings was conducted separately from the NARUC process. Except for partial completion of an audit of the BellSouth Corp. telcos' affiliate dealings, the other Bell company joint audits still are under way (*TR*, April 4).

The Southwestern Bell audit report questioned SBC allocations totaling $92.4 million. Of this amount, $62.2 million results from the exclusion of costs directly assigned to stockholders in calculating the general allocator for regulated versus unregulated costs. "The audit team believes that this practice is contrary to regulatory costing standards [FCC rule section 64.901], which require that the general allocator be computed by using the ratio of all expenses directly assigned or attributed to activities or subsidiaries, including costs assigned to the stockholders."

The remaining $30.2 million in SBC cost allocations are at issue because of the allocator used for indirect marketing costs. The audit report states: "SBC allocates its indirect marketing costs—those costs that cannot be directly assigned to a subsidiary—by the use of a marketing allocator derived from the sum of SBC's directly assigned marketing costs to its subsidiaries as well as the direct marketing costs incurred by those subsidiaries. This practice is not in conformance with the regulatory standards and procedures for the apportionment of joint and common costs, which require 'all costs that can be apportioned on the basis of direct assignment or cost-causational attribution measures to be so apportioned. Residual marketing expenses will be divided between regulated and nonregulated activities based on the ratio of the directly assigned and attributable costs.'"

The audit team interpreted this rule to mean that "only the costs directly assigned and attributed, if any, to the various subsidiaries by the apportioning company should be included in the computation of the marketing allocator."

Regarding the audit team's concerns about the lack of "supporting documentation for time charging by SBC's employees," the report says: "The audit team was not provided and could not review the adequacy of the results of the survey time studies for the audit period 1989-1992. Consequently, the audit team could not determine the reasonableness of SBC's expenses charged to [Southwestern Bell Telephone]. The audit team was told by a representative of SBC that at one time, four-week-survey time studies were made, but that none are currently available. Section 32.12(b) of the Uniform System of Accounts for telecommunications companies requires, in part, that 'the detail records shall be filed in such manner as to be readily accessible for examination by representatives of this Commission.'"

Accounting rule experts told *TR* that this problem may be difficult to resolve retroactively, but the FCC or states might order the telco to conduct time surveys to correct the problem on a forward-going basis. And if the telco were found to be in violation of rules in this regard, the FCC, at least, could impose a forfeiture on the company.

The audit questions Asset Management Inc., allocations totaling $1.3 million. The alleged overcharges to telephone ratepayers involve office space leased by the telephone company at more than the prevailing market price, as well as various charges to the telco in connection with a block of reserved rooms at a hotel in which AMI has an ownership interest. The report also mentions that regulators might want to review the allocation to the telephone company of more than 50% of the costs of relocating corporate headquarters from St. Louis to San Antonio, Texas. "The audit team deems that SBC has not provided adequate justification for these costs to be allowable and recoverable from the telephone ratepayers," the report says.

The Southwestern Bell joint audit team also reviewed the allocations of costs by the company's research affiliate (Southwestern Bell Technology Resources, Inc.) and the pricing of products and services provided by the phone company to its equipment (Southwestern Bell Telecommunications, Inc.) and cellular telephone service (Southwestern Bell Mobile Systems, Inc.) units. The audit report said that nothing was revealed to "indicate that the allocation of costs or the pricing of and recording of the transactions charged by all three affiliates were not in compliance with the applicable affiliate transaction standards. Furthermore, nothing came to the attention of the audit team that would indicate that the telephone ratepayers have been adversely affected by transactions between these three affiliates and [Southwestern Bell Telephone] for noncompliance with these standards."

Rebuttal Says Erroneous Results Were Reached

The audit report includes Southwestern Bell Telephone's detailed rebuttal to the audit team's findings and the auditors' reply to that rebuttal. Regarding the employee time survey issue, Southwestern Bell argued that these studies "are an insignificant element of SBC time reporting and are used for the sole purpose of evaluating positions whose responsibilities have changed. More integral to the entire time reporting system are the FASC Information Cards which each employee signed each year verifying their time charges. Once this happens, prior time records are inconsequential."

On the subject of marketing expenses, the rebuttal says that the audit team reached erroneous results. It states: "The audit team reaches a result whereby Southwestern Bell Telephone, the largest SBC subsidiary, would receive a zero cost allocation from the parent for image advertising which clearly benefits [the telephone company]. The audit team also adjusted the SBC general allocator to include retained expenses that are not assigned or allocated. The effect is to substantially distort [Southwestern Bell Telephone's] fair share of, and primary role in continuing the need for, such costs."

In addition, the rebuttal states that "in an effort to verify lease charges to [Southwestern Bell Telephone] from AMI, the audit team averaged the lease payments of nonaffiliates. [Southwestern Bell Telephone] was not aware this was an acceptable methodology for determining [the] prevailing price." The rebuttal also complains that the audit team overestimated the effects of its findings. ❑

Missouri Passes SFAS-106 Bill; Price Cap Measure Dies

The Missouri Legislature has adjourned without passing a bill that would have eliminated earnings restrictions on Southwestern Bell Telephone Co., so long as the telco caps basic local service and exchange access rates at current levels (*TR*, April 4). Despite fierce lobbying from the telco and the Communications Workers of America, the measure was not brought up for a vote in the state Senate. The measure also would have required the telco to make a $200 million annual capital commitment to deploy an advanced telecommunications infrastructure. At least $25 million of that total was to be earmarked for deploying fiber optic links to schools, hospitals, and law enforcement agencies.

Meanwhile, the Legislature passed a modified version of HR 1405, a bill requiring the state Public Service Commission to permit utilities to recover expenses associated with Statement of Financial Accounting Standard No. 106 (SFAS-106). The version finally adopted says that the PSC "shall not disallow or refuse to recognize the actual level of expenses the utility is required by [SFAS-]106 to record for post-retirement employee benefits for all the utility's employees, including retirees, if the assumption and estimates used by a public utility in determining the [SFAS-]106 expenses have been reviewed and approved by the commission, and such review and approval shall be based on sound actuarial principles."

Further, the measure states: "A public utility which uses [SFAS-]106 shall be required to use an independent external funding mechanism that restricts disbursements only for qualified retiree benefits. In no event shall any funds remaining in such funding mechanism revert to the utility after all qualified benefits have been paid; rather the funding mechanism shall include terms which require all funds to be used for employee or retiree benefits." The measure adds that the section "shall not in any manner be construed to limit the authority of the commission to set rates of any service rendered or to be rendered that are just and reasonable" under state law.

HB 1405 specifies that any utility that was the subject of a rate case proceeding decided subsequent to Jan. 1, 1993, and prior to the effective date of the new law, may file tariffs modifying rates to recover

NARUC AUDIT STAFF REPORT ON BELLCORE's R&D SPENDING FINDS RATEPAYERS ARE FINANCING COSTS RELATED TO COMPETITIVE SERVICES, RECOMMENDS MAJOR ACCOUNTING CHANGES; BELLCORE SAYS PROPOSALS ARE SPECULATIVE AND ARBITRARY, COULD SLOW NETWORK MODERNIZATION

Wholesale changes in the ratemaking treatment of Bell Communications Research's R&D expenses have been recommended by a National Association of Regulatory Utility Commissioners staff task force. In a report on "phase II" of the audit of Bellcore, which was "received" by NARUC's Executive Committee at its Nov. 17 meeting in Los Angeles, the task force recommended that Bellcore's R&D efforts be classified as competitive, non-competitive, or potentially competitive. It argued that "product costs directly attributable to competitive services should be taken below the line and not recovered from the general body of ratepayers."

Moreover, R&D expenses "should remain above the line if they are directly attributable to either non-competitive or potentially competitive services," the task force continued. But to protect current ratepayers, these expenses should be capitalized, not expensed, "if they are directly attributable to potentially competitive services or common to non-competitive and potentially competitive services," it said.

The task force based its recommendations on an examination of Bellcore's work in eight broadly defined product areas for the 1989-1990 period. These included broadband networks and services, personal communication services (PCS), and intelligent network designs and applications. These areas represented about 5% of all R&D projects undertaken by Bellcore and about 10% of its expenditures in those two years.

HIGHLIGHTS; Task force points out that recommendations do not represent official position of "any regulated jurisdiction". . .Bellcore says report "suffers major infirmities," does not want conclusions endorsed. . .Report says expensing R&D costs raises problem of fairness to current ratepayers. . .Recommendations made on treatment of products/projects for ratemaking purposes.

The task force noted that while FCC staff members participated in phase II, "the views, conclusions, and recommendations contained in this report are those of the project team members from the various state commission staffs participating in the audit, and do not necessarily represent the official position of any regulated jurisdiction." It added that the report's recommendations "are intended for state ratemaking purposes."

In scathing comments on the task force's proposals, which were appended to the document, Bellcore said that the report "suffers major infirmities: (1) It is not an audit, but rather an effort by the accounting task force to launch a new, untested ratemaking paradigm; (2) it mischaracterizes the nature of Bellcore's work; (3) its recommendations to 'capitalize' R&D work on some Bellcore programs is contrary to the best interests of the ratepayer; (4) it is contrary to the Generally Accepted Accounting Principles (GAAP) followed by most states and the FCC; and (5) it is contrary to a vast array of current FCC rules and common carrier law on disallowances and notice." Bellcore said, "It is of more than passing interest that the FCC has not endorsed the analysis, conclusions, or recommendations in this report," and it urged NARUC not to do so either.

In its report, the task force explained that "the problem with expensing R&D costs is one of fairness to current ratepayers." Bellcore's expenditures "are charged to the Bell regional holding companies, passed through to the operating companies, and for the most part (are) paid for by the general body of ratepayers," it explained. It said that "expensing all of Bellcore's costs" means that "consumers of today's non-competitive telecommunications services are, in effect, paying for the development of services to be introduced in the future.

"To the extent that such future services are classified as competitive and the associated costs and revenues (are) taken below the line, consumers of today's non-competitive services will not be able to share in the profits from the sale of these future services, even though they are currently funding their development," it continued. "Hence, we believe that in certain instances, Bellcore's product costs should be capitalized so that the costs of developing future competitive services will be borne by consumers of those services."

The task force recognized that capitalizing R&D costs associated with potentially competitive services or common to non-competitive and potentially competitive services would conflict with GAAP. Because future returns from R&D expenditures are "highly uncertain," GAAP requires that they be expensed. But it said that its proposal "may be the only solution to protect the current body of ratepayers" and that it "strikes an appropriate balance between fairness to ratepayers and encouraging R&D."

Elaborating on the proposal, the task force recommended that "capitalized R&D outlays be included in the rate base. Amortization of the capitalized costs could not begin until the services which the R&D costs support are finally determined to be non-competitive or competitive. In the meantime, the capitalized R&D expenditures should be permitted to earn the same authorized rate of return as other telecommunications assets in service." Not to allow the capitalized R&D to earn a return "would unduly discourage spending on R&D activities," it believed. "Moreover, because R&D is inherently uncertain, projects initially intended to support competitive services may yield unexpected results beneficial to non-competitive ratepayers," it noted.

The task force made specific recommendations about how the various Bellcore products and projects it examined should be treated for ratemaking purposes. Because future integrated broadband services may or may not be competitive, Bellcore's work on broadband integrated services digital networks (B-ISDN), switched multimegabit data services, fiber-in-the-loop, and Synchronous Optical Network should be classified as potentially competitive, it said. Related costs should be included in the rate base, but should be capitalized, it continued. The future competitiveness of PCS is "largely dependent upon resolution of spectrum allocation issues," so PCS-related costs also should be carried above the line and capitalized, the task force said.

The Information Networking Architecture that Bellcore is developing likely will support both competitive and non-competitive services, the report noted. It said that the costs involved, therefore, should be above the line but capitalized, "allowing the Bell operating companies a return on such expenditures until a more definitive determination can be made (regarding) the competitiveness of the services ultimately offered."

The report recommended that costs for developing Bellcore's "800" data base access service be carried above the line and expensed--except in states that impute access charges, where intraLATA 800 services should be considered competitive and the associated Bellcore costs should be taken below the line. Similarly, the task force said that costs for four of Bellcore's alternate billing service projects "should be kept above the line and expensed." But the costs for three other projects "conducted in support of the competitive aspects of alternate billing services" should be taken below the line, it added.

Work on Bellcore's narrowband ISDN "product" is "primarily intended to support non-competitive services," so the expenses related to it should be above the line and expensed, the task force said. With one exception, so should costs for common channel signaling R&D and for work on the Advanced Intelligent Network, it said. The exception involved costs for one AIN-related project "devoted exclusively to competitive data services," and the task force said those costs should be accounted for below the line.

The task force defined competitive services as those that "are supplied under conditions which make market competition an effective mechanism for controlling price, quality, and other terms." Non-competitive services exist "where market competition does not control" these variables, it continued. "Potentially competitive" services were defined as "services where market competition could become effective in the future, depending" on technological change, the "resolution of particular public policy issues," and other "changing circumstances."

The products and projects reviewed by the task force all were managed by Bellcore's "network segment," one of four business segments at Bellcore. The task force "strongly" recommended that "future audits of Bellcore examine in depth the activities of the 'integrated operations segment,'" which is the largest of the four units, accounting for about 48% of Bellcore's budget in 1991. The task force also recommended that the federal-state joint audits of the RHCs' affiliate transactions (see separate story) "investigate how R&D undertaken in the regions is related to Bellcore's activities."

Bellcore said that under the task force's recommendations, $32,880,000 of its R&D expenses for 1989 and 1990 would have been accounted for below the line, and that another $59,780,000 would have been capitalized. Among Bellcore's many criticisms of the report was the task force's classification of its R&D activities as "speculative and arbitrary." Moreover, it said, the "thrust of the entire proposal"--that it "will solve 'intergenerational inequity' and that it will be 'fair' to today's ratepayers"--is "misleading and does not fairly represent the real impact of the proposal.

"The real result of the proposal to capitalize certain R&D expenses would be to risk non-recovery of the Bellcore R&D investment entirely, unfairly and excessively shifting the burden of supporting current R&D to shareholders." Bellcore said that "shifting expenses for R&D work to capitalization accounts under the Uniform System of Accounts would seriously dampen the incentive for shareholders to invest in the telephone companies, thereby risking the possibility of stagnating modernization of the current network."

Bellcore added that "whether or not the increasingly competitive nature of the telecommunications marketplace warrants an examination of the current state of the law regarding state ratemaking policies should not be an issue in the current audit. Any effort to apply new standards created by the (audit) team itself to past Bellcore

R&D expenses, and then make negative findings, is clearly beyond the scope of normal auditing procedures."

A year ago, the initial phase of the first joint federal-state audit of a major telecom company found that Bellcore overbilled the RHCs by $79,800,000 for the period 1984 to 1990 (TR, Nov. 4 and 18, 1991; and Jan. 27). The "Phase I" audit addressed Bellcore's financial results, budgeting, cost accounting, and billing processes. Phase II focused on Bellcore's technical work efforts. -End-

NATIONAL CONFERENCE OF STATE LEGISLATURES TO GET PLEA TO SAVE COMMUNICATIONS PANEL

Leadership of the National Conference of State Legislatures (NCSL) and the Communications Committee of its State-Federal Assembly have recommended that the NCSL Executive Committee review a proposal to jettison the committee as now constituted (TR, Aug. 10 and Nov. 9). The Executive Committee is expected to take up the recommendation when it meets Friday, Dec. 11, on the third day of the State-Federal Assembly (SFA). NCSL officers met in Raleigh, N.C., Nov. 13 to discuss the Communications Committee's future. One reason advanced for keeping the committee in business was recent passage of the federal law to re-regulate the cable TV industry. The officers believe that the law dictates a review of state and local government regulatory roles.

The SFA committee was discussed during meetings of the Conference's separate Assembly on the Legislature. This is a forum for the exchange of ideas, emphasizing state regulation, whereas the State-Federal Assembly develops NCSL policy and lobbying positions. The proposal that the Executive Committee is being asked to review would merge the communications group with an existing committee in the Assembly on the Legislature. This assembly has created its own Communications and Information Policy Committee, superseding an Information Policy Task Force.

Another reason advanced for keeping a Communications Committee in the State-Federal Assembly was a wish to review NCSL's position on cable TV regulation in light of the federal legislation. In addition, rapid changes in the telecom industry require monitoring of implications for both state and federal regulation, advocates said. It was emphasized, too, that the committee spent this year reviewing complicated technical issues and now is ready for an active role in lobbying activities.

Among those arguing to keep the Communications Committee under the State-Federal Assembly umbrella were Arizona Rep. Art Hamilton, the incoming President of NCSL; and Delaware Sen. Bob Connor, President-elect. California Assemblywoman Gwen Moore, a committee activist who will become the head of the State-Federal Assembly in 1993, also wanted to keep the committee in place. So did New York Sen. Jim Lack, 1992 Chairman of the SFA. Committee members arguing to save their panel were the 1992 committee Chairman, Illinois Rep. Bill Black; Alabama Rep. Al Knight and Kansas Rep. Phil Kline, Vice Chairmen; and committee member Karol Pirsch, state Senator of Nebraska. -End-

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Bell Atlantic Mobile Systems has unveiled a cellular facsimile service based on the Mitsubishi FIO Access portable fax machine. The Mitsubishi machine can be linked, with a data interface, to most cellular phones so that messages can be transmitted over the existing cellular network. The machine also operates with a landline connection. The Bell Atlantic Mobile service will give "mobile workers" access to hard copies of diagrams, work orders, schematic diagrams, and other critical information at their remote work sites. -End-

Joint Audits of SW Bell, Ameritech, Pacific Telesis Near End; Controversies Continue to Stall BellSouth, NYNEX Reviews

After a long and contentious process, several state-FCC joint audits of Bell company affiliate transactions are nearing completion. At least three affiliate transaction audits—involving Southwestern Bell Corp., Ameritech Corp., and Pacific Telesis Group—are expected to be completed by the time the National Association of Regulatory Utility Commissioners meets in late July. The audit reports will be presented to NARUC's Finance and Technology Committee, which sponsored the NARUC resolution that launched the project several years ago (TR, Nov. 18, 1991). Public release of the audits is expected in July, provided that state commission and FCC rules have been satisfied.

HIGHLIGHTS: Rhodes believes audit findings will be useful even to states with incentive, price cap regulatory regimes. . .After court upholds PSC directive, BellSouth asked to comply with audit team's data requests by April 11. . .Investigation report expected in several months regarding allegations that NYNEX employees obtained advance copy of audit. . .Bell Atlantic audit due next fall.

Finance and Technology Committee Chairman Joseph Rhodes Jr., who is Vice Chairman of the Pennsylvania Public Utility Commission, recently told TR that he thinks the audits will be worth the wait. "I believe that the audits will produce very useful data. I don't think the data only will be useful to states that do cost-based regulation, but also to states that do incentive and price indexing regulation."

He said that it was "unfortunate" that the audit process was difficult. "But we expected that if the audits were worth doing, they would not be done easily," he said. Mr. Rhodes noted that "each audit has a different character and scope," and that "controversies concerning access to unregulated affiliate information, treatment of proprietary information, and the portability of information across state lines, were dealt with uniquely by the commissions in each [Bell] region."

According to the NARUC/Federal Staff Audit Oversight Committee, the Southwestern Bell audit report has been completed, and the company's written comments have been submitted. Public release still must be authorized by the FCC and a state commissioners' oversight committee that includes representatives from the five state commissions in Southwestern Bell's region. A draft report on the Ameritech audit is expected to be presented to the FCC and state commissioners in the company's region in May. This joint audit focuses only on the Ameritech Services affiliate. The Ohio Public Utility Commission alone audited Ameritech Publishing. The Pacific Telesis audit report—focusing on the company's Yellow Pages publishing, research and development, and enhanced services affiliates—is not expected to be completed until July.

Because of recent developments, the BellSouth audit may not be ready in July. The Florida Public Service Commission released a redacted version of the audit report last December in connection with a Southern Bell Telephone & Telegraph Co. rate review proceeding. In that document, the audit team complained that the report was incomplete because of BellSouth's "consistent pattern of obstructionist behavior since May of 1992." Specifically, the company had argued that state law did not grant the PSC the right to obtain the affiliate information the audit team had requested. And it had litigated the PSC's directive that it release the requested affiliate data.

Last month, the Florida Supreme Court ordered Southern Bell to comply with the audit team's requests for data. The court said, "In the eyes of Southern Bell, the issue is whether the affiliates' general ledgers and financial statements are within Southern Bell's possession, custody, or control. In our eyes, however, the issue presented by this case is whether [state law] provides the PSC with the authority to gain access to the records of Southern Bell's affiliates. We hold that the statute's plain language authorizes the PSC's access to the affiliates' records requested by the audit team."

Continuing, the court said that the "mission of the audit team was designated by NARUC and is consistent with the PSC's regulatory power to ensure against cross-subsidization. The audit team is not involved in legal proceedings before the PSC or before this court. Thus, because NARUC's request for the affiliates' documents was not sought in furtherance of a legal discovery effort, the documents are subject to the statute governing the regulation of telephone companies and not to the rules of discovery." According to the December audit report, the BellSouth audit was conducted under Florida statutes and rules because the PSC had been given "broad authority" over affiliate relationships.

The court ruling also addressed documents that the state Office of Public Counsel was pursuing in connection with its request that the commission investigate allegations that Southern Bell employees had falsified repair reporting information (TR, April 8, 1991; and July 20 and Oct. 19, 1992). The PSC had directed Southern Bell to comply with these requests as well, prompting more appeals to the courts. The Florida Supreme Court ordered Southern Bell to comply with most, but not all, of these requests for information.

In light of the court ruling, Florida PSC Director-auditing and financial analysis Timothy Devlin wrote to BellSouth Telecommunications, Inc., March 28, asking that the company comply with more than 30 requests for data by April 11. The company's responses may prompt the PSC staff and the state-FCC audit team to expand the audit beyond the findings in the December report. The PSC also has not ruled on whether the company's requests for proprietary treatment were valid regarding the information that was redacted in the December report.

Another factor that may affect whether the BellSouth audit is reopened involves a settlement agreement negotiated earlier this year between Southern Bell, the state's Public Counsel, and other parties in the Florida rate review proceeding. Under the settlement, the telco agreed to cut its rates by $300 million over three years. A PSC staff member told TR that the settlement did not necessarily mean that there is no need to continue the audit. "If new issues are uncovered, I don't think the settlement forecloses the commission from deciding to act on them," he said. The December audit report also noted that seven of the nine state commissions in BellSouth's region supported the audit effort. These commissions may want to continue the audit after the Florida staff receives the requested data.

Completion of the NYNEX Corp. joint audit report depends on the completion of a retrospective affiliate transaction audit ordered by the New York Public Service Commission. This retrospective audit involves New York Telephone Co.'s affiliate dealings between 1984 and 1990. But it is on hold pending the [illegible] investigation into allegations that New York Tel personnel obtained an advance copy of [illegible] 20, 1993; and Jan. 17). The consultant conducting the audit—Liberty Consulting [illegible] and PSC staff are investigating the alleged security breach to determine if [illegible] was compromised. The results of the investigation are not expected to be [illegible], a commission spokeswoman said. New York Tel reportedly is conducting its [illegible] allegations.

The Bell [illegible] only the Pennsylvania and District of Columbia commissions are [illegible] be released until September, 1995. In February, the Pennsylvania PUC [illegible] the independent auditor. A multistate audit of U S WEST Communica[illegible] separately from the NARUC project. Its results were released 18 mnonths ago [illegible] NARUC audits got off to a bad start in 1992 when Bell companies [illegible] not have the authority to conduct the audits and that their focus [illegible] or pending state audits (TR, Jan. 20 and 27, 1992).

The Bell [illegible] the audits. NARUC eventually narrowed the scope of the audits to [illegible] tions, and the individual state commissions pursued the audits [illegible] for conducting and funding such activities (TR, March 9, 1992). [illegible] have complained that most of the Bell companies have stalled [illegible] requests (TR, Nov. 23, 1992). ❑